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C O N F I D E N T I A L SECTION 01 OF 03 CARACAS 002807

SIPDIS

NSC CBARTON
ENERGY FOR CDAY, DPUMPHREY, AND ALOCKWOOD
STATE FOR EB/ESC/IEC/EPC MMCMANUS

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SUBJECT: THE OIL AND GAS SECTORS: NEW DETAILS EMERGE

REF: A. CARACAS 01496

¶B. CARACAS 02506
¶C. CARACAS 02387
¶D. CARACAS 02596

Classified By: Economic Counselor Andrew Bowen for Reason 1.4 (D)

SUMMARY

¶1. (C) The GOV announced the winning bids for Phase A of the Rafael Urdaneta offshore gas tender on September 8. Five out of a total of twenty-nine companies that purchased data packs bid on four blocks. An oil executive, who previously held senior positions in PDVSA, expressed surprise over the size of Gazprom's bids but said Chevron's bid made sense. The GOV's position regarding back taxes owed by companies with Operating Service Agreements (OSAs) has raised a number of legal questions that it has studiously avoided. Finally, the eight companies that signed MOUs for development of eight blocks of the Faja that contain heavy and extra heavy crude may not have received as good of a deal as originally thought. END SUMMARY

Rafael Urdaneta Offshore Bid Round

¶2. (C) The GOV announced the winning bids for Phase A of the Rafael Urdaneta (located beside the Paraguana Peninsula) offshore tender on September 8. Gazprom was awarded Urumaco I with a bid of USD 15.2 million and Urumaco II with a bid of USD 24.2 million. Chevron was awarded the Cardon III with a bid of USD 5.6 million. A Petrobras/Teikoku consortium bid on Urumaco III but the GOV did not accept the offer on the grounds it was too low. The Italian oil company ENI bid on Urumaco II but lost out to Gazprom. Although twenty-nine companies purchased data packs, only five actually bid. Vinccler Oil and Gas was going to bid on the La Vela Sur block but decided against it on the grounds that the block was too small. Under the best conditions, the reserves in an area the size of La Vela Sur would have required a gas price well above what the GOV would have permitted in order for the block to be commercially viable. Since production from Rafael Urdaneta is destined for the domestic market, Vinccler did not believe the block was commercially viable.

¶3. (C) An oil executive who previously held senior positions in PDVSA told Petroleum Attache (Petatt) that his company purchased a data package but did not bid because it did not think it could develop the blocks in an economically viable manner. He stated he was mystified by the Gazprom bids because he believed the Urumaco I block was much better than Urumaco II. He noted, however, that his company did not believe that either block held significant amounts of reserves that could be developed in an efficient manner.

¶4. (C) When Petatt expressed surprise that Chevron bid in the round, the executive said it made perfect sense. He said senior Chevron executives told him the company wanted to significantly increase its activities in the gas sector and viewed Venezuela as an ideal location since the sector was underdeveloped. Although Rafael Urdaneta's production is slated for the domestic market, the executive believes Chevron is willing to invest in the project since Rafael Urdaneta's production combined with potential production from Mariscal Sucre should sate the domestic market's demand. This would allow Chevron to export a greater percentage of gas production from its crown jewel, the Deltana Platform, which is located east of Trinidad and Tobago. The executive believes Chevron will try to participate in Mariscal Sucre, which is located west of Trinidad and Tobago, for the same reasons.

TAXES

¶5. (U) As reported in Reftels A and B, oil companies with OSAs are facing a GOV audit. The GOV claims the companies owe substantial back taxes because the oil companies are acting

as "oil producers" rather than "service companies". Service companies have a 34 percent tax rate, do not pay royalties, and are subject to municipal taxes. Oil producers have a 50 percent tax rate, are required to pay royalties, and are not subject to municipal taxes.
¶6. (C) According to an international oil company's (IOC) general counsel, oil companies operating under an OSA do not take title to hydrocarbons. The companies under the OSA were required to purchase capital goods on behalf of PDVSA. Under the OSA, the companies' compensation is based on the following formula: Prorated capital expenses plus operating expenses plus interest expense plus production incentives. Since companies' compensation is limited by a maximum total fee, they are permitted to roll over capital expenses over a period of 20 years. Companies earn interest on capital expenses that have been rolled over. The companies' profits come from operating expenses and production incentives. Since the operating expenses are based on a formula rather than actual expenses, differences due to operating efficiencies are pocketed by the companies as profit. The GOV bases part of its claim that the OSA companies are oil producers on the fact that their compensation fluctuates rather than being a set fee.

¶7. (C) The GOV has, in the finest tradition of Nelson, studiously turned a blind eye to a number of logical conclusions that its position reaches. If companies with OSAs are oil producers, then they should be subject to paying royalties. However, the general counsel noted most of the OSAs would no longer be economically viable if they were subject to royalties. It appears GOV officials have completely avoided the issues of royalties in discussions with the oil companies.

¶8. (C) The GOV's position also raises doubts about the status of independent service companies such as Schlumberger and Halliburton. Up till now, the GOV position appears to be that these companies are clearly service companies since they receive a fixed fee for their services. However, senior service company officials have told us that PDVSA has approached them about providing oilfield services on a risk reward basis rather than a traditional fee for services basis. If the independent service companies did decide to provide services on a risk reward basis, it is conceivable under the GOV's current definition of "oil producer" that the service companies could be opening themselves up to higher tax rates. If PDVSA and the GOV are serious about enticing independent service companies into taking on more risk, the GOV's tax policy may very well have shot this initiative in the foot.

¶9. (C) The GOV's drive to treat companies with OSAs as oil producers appears to have had unintended consequences for municipal governments. As noted above, oil producers, unlike service companies, do not have to pay municipal taxes. According to industry insiders and the press, Repsol, which has signed a transitory agreement to migrate its OSA to a joint venture company in which PDVSA has majority control (Reftel C), has apparently told municipal governments that it will no longer pay municipal taxes. In addition, Repsol's legal counsel told Econ specialist that the municipal governments will have to forfeit the taxes that they have collected in the past. Since municipal governments frequently receive more in municipal taxes than they do from central government funding, the impact on municipal governments could be huge. Deputies from affected areas have already made statements in the press claiming the oil companies must continue to pay municipal taxes. The Repsol counsel was pessimistic about the company's chances to press their claim for back municipal taxes due to the politically explosive nature of the claim. It is not clear whether other oil companies will follow Repsol's lead.

DEVELOPMENT OF THE FAJA

¶10. (C) The GOV announced, as part of its hydrocarbon plan "Siembra Petrolera" (Reftel D), signed MOUs with eight foreign firms for the development of eight blocks of the Faja area of the Orinoco basin. The area contains major reserves of heavy and extra heavy petroleum. (Note: Classifying the 236 billion barrels of Faja reserves as petroleum and combining it with the 77 billion barrels of proven reserves would give Venezuela the largest liquid hydrocarbon reserves in the world. End Note). Under the MOUs, the firms must first carry out studies to certify the reserves in the eight blocks. According to the oil executive who formerly worked for PDVSA, officials at the Ministry and PDVSA realized at the last minute that the firms would have an inherent conflict of interest. In order to bolster their bargaining position when it came time to form joint ventures to exploit the blocks, it is in the firms' interest to come up with a low number for reserves. In order to reduce the risk of the firms low balling their reserve figures, the GOV placed language in the MOUs at the last minute that stated the firms may not receive the blocks where they carried out the studies

to certify the reserves.
Whitaker